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Determinants of financial reporting quality: Local government status as moderator

Satrio Kusumo Yudhanto^{1*}, and Evi Rahmawati²**AFFILIATION:**

¹Master of Accounting, Universitas Muhammadiyah Yogyakarta, Special Region of Yogyakarta, Indonesia

²Department of Accounting, Faculty of Economics and Business, Universitas Muhammadiyah Yogyakarta, Special Region of Yogyakarta, Indonesia

***CORRESPONDENCE:**

satriokusumo34@gmail.com

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JAI Website:**Abstract**

Research Aims: This study aims to examine the effect of capital expenditure and local government size on financial reporting quality, with local government status as a moderating variable in Indonesian local governments.

Design/Methodology/Approach: The study was conducted on municipal and district governments in Indonesia, covering 379 districts and 87 municipalities, with a total sample of 466 local governments. Data collection was carried out through documentation, with data sourced from audited financial reports of local governments by the Supreme Audit Board. Hypotheses were tested using Moderated Regression Analysis (MRA) with the Eviews 12 software.

Research Findings: The results of this study indicate that the variables of capital expenditure and local government size have a significant positive effect on the financial reporting quality of local governments in Indonesia. Furthermore, the local government status variable can moderate the effect of capital expenditure on financial reporting quality, but it cannot moderate the effect of local government size on financial reporting quality in Indonesian local governments.

Theoretical Contribution/Originality: This study adds local government status as a moderating variable for the relationship between capital expenditure, local government size, and financial reporting quality.

Keywords: Capital Expenditure; Financial Reporting Quality; Local Government Size; Local Government Status

Introduction

Indonesia, as a democracy with a fiscal decentralization system, faces significant corruption challenges (Rakhman & Wijayana, 2019). One of the Indonesian government's efforts to reduce corruption is that since 2004, almost 500 local governments in Indonesia have been required by Law No. 17 on State Finance issued in 2003 to prepare and submit annual reports which are then audited by the Supreme Audit Agency (SAA). This is a form of the central government in encouraging accountability and transparency of financial reporting. Therefore, financial reporting quality (FRQ) is an interesting topic to research, because in general in the accounting and governance literature, research on financial reporting quality focuses on companies (Dechow et al., 2010; Lo, 2008) and non-governmental non-profit organizations (Hofmann & McSwain, 2013). In Indonesia itself, although the law requires local governments to prepare annual audited financial statements, studies on FRQ in the public sector are still minimal.

In a corporate environment, FRQ is influenced by top management characteristics (Francis et al., 2008; Habib & Hossain, 2013; Jiang et al., 2013; Rakhman, 2009) and audit, committee and board effectiveness (Badolato et al., 2014; Krishnan & Visvanathan, 2007; Vafeas, 2005). Other studies found that firm-specific factors such as audit quality (Stanley & Todd DeZoort, 2007), capital structure, and business arrangements (Rahman et al., 2010), employee quality (Call et al., 2017), corporate reputation (Cao et al., 2012), and reporting incentives (Christensen et al., 2015) have a significant impact on FRQ. Institutional factors such as investor protection, culture, and financial reporting standards/regulations also affect FRQ (Barth et al., 2008; Houqe et al., 2012; Nabar & Boonlert-U-Thai, 2007; Wijayana & Gray, 2018). However, research examining the factors that influence FRQ in the context of government institutions (public sector) is still very limited, this is because the reporting environment is significantly different. The factors that determine the quality of reporting in a government environment are likely to be different from the factors that determine the quality of reporting in a corporate or non-government environment.

This study examines the determinants of local government FRQ in Indonesia. Investigation of the factors that influence FRQ in the context of local governments in Indonesia, namely level II local governments such as districts, and cities. Indonesia is interesting to study because based on the principle of regional autonomy, local governments in Indonesia have the right, authority, and obligation to regulate government affairs in accordance with the interests of their communities, as stipulated in Law No. 23 of 2014. As a form of accountability to the public, local governments are required to prepare financial reports, the preparation of which is guided by Government Regulation No. 71 of 2010.

In addition, investigating the determinants of FRQ in the context of local government in Indonesia is interesting for the following reasons. First, Indonesia is an example of a young country but one of the largest democracies promoting fiscal decentralization and public sector reform. Since 2004, local governments in Indonesia have been required by Law No. 17 on State Finance issued in 2003 to prepare and submit annual reports, namely financial statements, which are then audited by the SAA (Rakhman & Wijayana, 2019). To ensure that local government financial reports are reliable and in accordance with regulations, the SAA as an external auditor is tasked with conducting an audit, as stipulated in Law No. 15 of 2004. This audit aims to ensure that financial statements are prepared correctly, detect potential fraud, and enforce compliance with regulations as described by Kinney Jr & McDaniel (1989) and Tambingon et al. (2018).

Requiring all government agencies to prepare annual reports is an important step in promoting accountability and transparency. While such requirements may be necessary, good accountability and transparency alone will not be enough unless the country addresses FRQ issues. However, empirical studies on the factors that influence FRQ in the public sector, especially in Indonesia, are still limited. (Rakhman & Wijayana, 2019).

Second, in a country like Indonesia, which is still characterized by corruption at all levels of government, increasing accountability and transparency through local government FRQs has the potential to strengthen preventive measures against corruption involving

government officials. Corruption remains a serious challenge to public management reform in the country (McLeod & Harun, 2014), and needs to be addressed comprehensively. In addition, the Indonesian central government's strong efforts to encourage accountability and better financial reporting practices among local governments make Indonesia an attractive place to conduct research on local government FRQs.

Various studies have used audit opinion on financial statements as an indicator of FRQ (Adiputra et al., 2019; Din et al., 2017; Suwanda, 2015). The Fair Without Exception opinion obtained by the local government indicates that the financial statements are presented in accordance with applicable regulations and are free from material errors. A better opinion reflects a higher level of transparency and accountability, which in turn improves the quality of financial statements.

Several factors are expected to influence this study, namely, capital expenditure, local government size, and local government status. The use of capital expenditure by local governments affects the level of supervision by the central government, where it is expected that the higher the supervision by the central government, the better the resulting FRQ (Rakhman & Wijayana, 2019; Firmansyah et al., 2022).

This study uses agency theory as the main theory. The quality of local government financial reports is also demanded by various parties. One of the main parties is the central government, which wants to ensure that funds are used as intended and reported accurately based on applicable regulations (Rakhman & Wijayana, 2019). Theoretically, the results of this study are expected to contribute to the development of research on FRQ in the government (public sector) environment, especially related to factors that influence FRQ. The practical results of this study for local governments are to improve the quality of financial statements. So it is hoped that local governments in Indonesia can present quality financial reports that are useful for the public.

Literature Review and Hypotheses Development

Agency Theory

Agency theory discusses the contractual relationship between one or more people (principal) who command another person (agent) to perform a service on behalf of the principal and authorize the agent to make the best decision for the principal (Meckling & Jensen, 1976). This theory also applies several governance mechanisms to control the actions of agents in jointly owned companies (Panda & Leepsa, 2017). Local governments as agents will avoid risks in the form of public distrust of their performance. Therefore, the government will try to show that their performance has been good and accountable in managing regional finances (Purnomo, 2019).

The financial reporting mechanism as agent performance information is used to monitor agent behavior and align the goals of the principal and agent, the principal requires the

agent to be accountable for the resources entrusted to him (Scott, 2015). Through financial reports which are the responsibility of the agent, the principal can measure, assess and monitor the performance of the agent, to what extent the agent has acted to improve the welfare of the principal (Wulandary et al., 2022). To reduce conflict, monitoring by the principal is needed for what the agent does. Financial reports are one form of monitoring tool to reduce agency costs (Hasanah & Siregar, 2021).

Agency theory can be applied to the public sector (Zelmiyanti, 2016). Agency theory states the need for independent auditor services in this case SAA, this can be explained on the basis of agency theory, namely the relationship between the owner (principal) and management (agent) (Liya et al., 2020). The principal agent relationship framework is a very important approach to analyzing public policy commitments. Public policy making and implementation are related to contractual problems, namely asymmetric information, moral hazard, and adverse selection (Hasanah & Siregar, 2021).

The Effect of Capital Expenditure on Financial Reporting Quality

Capital projects encourage the growth of local governments, which to some extent will support financial reporting infrastructure and information and technology systems thereby increasing FRQ (Rakhman & Wijayana, 2019). In the implementation of decentralization, local governments have an obligation to make expenditures in the form of local expenditures. One important type of regional expenditure is capital expenditure which has a productive nature and can provide benefits in a period of more than one year. Effective use of capital expenditure (CAPEX) will create greater opportunities to maximize the potential for regional income, which in turn improves regional financial performance (Mardiasmo, 2021). This indicates that efficient, transparent, and accountable regional financial management will be reflected in financial reports that are clear, accurate, and easy to understand.

CAPEX in local government refers to expenditure used to purchase, build, or repair fixed assets that will be used in the long term, such as infrastructure, buildings, roads, or other public facilities. The effect of CAPEX on the quality of local government financial reports is very important, because this can affect transparency, accountability, and sustainability of local finances, one form of CAPEX in local government, is spending on developing human resources, one of which is in the fields of finance, and accounting, as well as developing infrastructure that can support the process of making quality reporting quality (Agustina & Setyaningrum, 2020).

CAPEX has a significant effect on the quality of local government financial statements. Transparent and accountable CAPEX management will improve the accuracy of financial statements, increase public confidence, and help make the right decisions. Conversely, poor CAPEX management can damage the quality of financial statements by reducing transparency, increasing financial risk, and reducing accountability.

Good CAPEX can improve the quality of financial statements because it ensures that capital expenditure is carried out with careful planning and for clear purposes. Proper

management of assets, financing, expenses, and risks related to CAPEX will result in financial statements that are more transparent, accurate, and reflect good financial health (Rakhman & Wijayana, 2019). Financial statements that reflect good long-term investments and are well managed will show sustainable growth and solid performance, which in turn increases the trust and reliability of the statements.

Local governments with a higher proportion of CAPEX in their budgets will have higher complexity, thus causing supervision by both the public and the central government to be stricter, this is in accordance with agency theory. Due to the use of higher CAPEX, local governments are required to carry out better management, and more transparent reporting, this is expected to increase FRQ. Based on the arguments, the first hypothesis can be derived as follows:

H₁: CAPEX has a significant positive effect on FRQ.

Effect of Local Government Size on Financial reporting quality

Revenue from local government comes from 2 things, namely from local revenue and from funds by the central government. The larger the size of the local government will have more resources which can produce better FRQ because it will lead to demands for better reporting transparency (Rakhman & Wijayana, 2019). In the public sector, the greater the resources will also facilitate operational activities which will then make it easier to provide adequate community services, where in this study local government size is measured using total local government assets.

Local governments with higher financial independence are considered richer because they derive more revenue from local sources, rather than from intergovernmental transfers. Richer local governments have greater resources to utilize information technology or hire consultants to support accounting systems, thus increasing the likelihood of producing higher quality financial statements. Tavares and da Cruz (2017) found that local governments with greater local revenues tend to be more transparent. In addition, the public has a greater incentive to monitor local governments when more revenue comes from local tax money. Geys et al. (2010) find that voter engagement improves local government performance only when financial independence is high.

Larger local government size is also associated with greater transparency towards their stakeholders (Behn et al., 2010; Gordon et al., 2002; Guillamón et al., 2011) and less likely to commit reporting errors (Gross & Neely, 2014), and more likely to provide voluntary online financial information reporting (García & García-García, 2010).

Local governments with more wealth caused by larger local government size are expected to be more transparent in their financial reporting, because the demand for quality financial reports will tend to be greater in local governments that have a large size, because the larger the size of the local government, the higher the local revenue which will increase the opportunity to commit fraud. This is in accordance with agency theory

because the public and the central government will be more observant of the use of funds derived from local revenues (Tavares & da Cruz, 2020). Based on the arguments, the second hypothesis can be derived as follows:

H₂: Local government size has a significant positive effect on FRQ.

The Effect of Capital Expenditure on Financial Reporting Quality with Local Government Status as Moderator

CAPEX in local government reflects local government policy for development. In general, local budgets are activity plans and resource allocations for local governments, where these allocations reflect local development funding policies. Local CAPEX budgets are often influenced by funding from the government and local revenue itself, where local revenue is obtained from local own-source revenue (PAD), which is a source of funds for local governments in developing infrastructure. This PAD includes revenue from local taxes, local levies, the results of the management of separated local assets, and other sources of PAD.

In the era of decentralization, local governments are expected to be able to develop and increase PAD by maximizing the potential of existing resources to fund infrastructure projects and facilities through the allocation of capital expenditures in the regional budget. The greater the PAD of a region, the greater the capital expenditure budget (Ardhani, 2011). Darwanto and Yustikasari (2007) also found that PAD has a significant and significant effect on CAPEX allocation, which indicates that PAD is one of the important factors in determining the CAPEX budget, where the greater the CAPEX allocation, the more complex the profit management will be, therefore local governments that have high CAPEX are required to present transparent and good financial reports. Especially if it has the status of a city, where people will tend to be more understanding and aware of the use of CAPEX.

In local governments that have city status, it is expected to have better FRQ because in addition to supervision by the central government which is stricter than local governments that still have district status, supervision by the community will also be higher, where it was found in research local governments that have city status have better FRQ. Rakhman and Wijayana (2019) stated, local governments that already have city status have better FRQ, this is because accounting and finance experts who want to work in the local government sector prefer institutions in more developed areas compared to small or remote areas, due to factors such as better quality of life, more adequate facilities and infrastructure, higher salaries, and better career prospects and employment opportunities (Berry & Glaeser, 2005; Glaeser & Resseger, 2010).

People in urban areas also tend to have a higher level of education, so they are more actively involved in decision making in their local government (Yang & Callahan, 2005). One of them is in the form of monitoring the use and disclosure of better CAPEX, this is in

accordance with *agency theory*. Based on the arguments, the third hypothesis can be derived as follows:

H₃: *Local government status significantly moderates the relationship of CAPEX on FRQ.*

The Effect of *Local Government Size on Financial Reporting Quality Local Government Status as Moderator*

Local governments that have city status tend to have a higher level of wealth, this may be due to the greater size of local government will have more resources, which can produce better FRQ (Rakhman & Wijayana, 2019).

The larger the local government size, has a tendency to have greater regional wealth obtained from PAD, so it is required to be more transparent in reporting its use (Geys et al., 2010) , especially if the local government already has city status, where people who have expertise prefer to live in local governments that already have city status tend to be more developed than areas that still have district status, due to factors such as better quality of life, more adequate facilities and infrastructure, higher salaries, and better career prospects and employment opportunities. According to Yang and Callahan, (2005) people in urban areas tend to have a higher level of education, so they are more actively involved in decision making in their local government, this is in accordance with what is explained in agency theory. Based on the arguments, the fourth hypothesis can be derived as follows:

H₄: *Local government status significantly moderates the relationship local government size on FRQ*

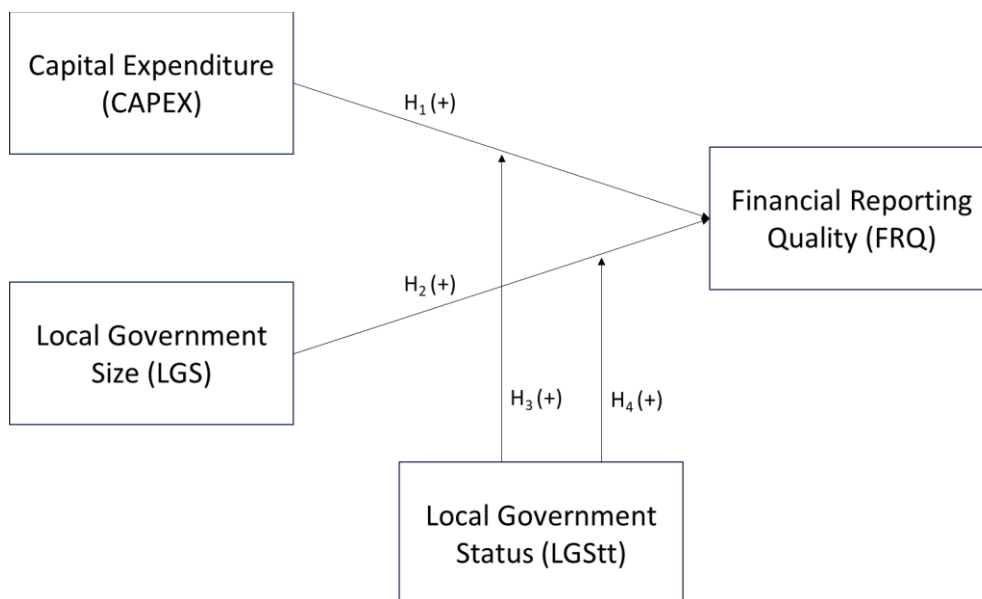


Figure 1 Research Framework

This research model is as illustrated in Figure 1, where it is suspected that the capital expenditure and local government size variables have a positive effect on financial reporting quality and the moderating variable local government status positively moderates the relationship between the capital expenditure and local government size variables with financial reporting quality.

Research Method

Population and Sample

This study uses a sample of financial reports published by Level II local governments, namely City and Regency level local governments in Indonesia in 2020. Here the Provincial Government is not involved, this is because the Provincial Government can intervene in the financial governance of the Regency and City level local governments, while this study prioritizes the independence of financial governance in local government.

Data Type

The data used in this study are secondary data. Secondary data in this study were taken from local government financial reports that have received an audit opinion by the Indonesian SAA.

Sampling Technique

The sample determination uses purposive sampling technique, namely determining the sample based on the suitability of the sample characteristics with the specified sample selection criteria. The sample criteria are the financial statements of local governments in Indonesia in 2020, Level II local governments consisting of cities and regencies, and have received audit results from SAA.

Data Collection Technique

This research uses quantitative data, so the data collection technique is done by means of documentation. Data sources are obtained from taken from local government financial reports that have been audited by the Indonesian Supreme Audit Agency. Hypothesis Analysis Techniques are tested using the Interaction Test or Moderated Regression Analysis (MRA) using Eviews 12.

Result and Discussion

This study uses data sourced from local government financial reports that have received an audit opinion from the SAA. Based on several purposive sampling criteria that have been determined, the results of sample selection using purposive sampling technique are presented in Table 1 as follows:

Table 1 Research Sample of Local Governments in Indonesia in 2020

Description	Total
Local governments in Indonesia	542
District and City	508
Outliers	(42)
Number of Sample data Used	466

According to the data listed in Table 1, there are 542 Level I local governments and Level II local governments in Indonesia. For Level II local governments consisting of regencies and cities as many as 508. So that the amount of sample data for local governments in Indonesia used after deducting outliers is 466 local governments.

Descriptive Statistics Test

Table 2 presents the results of the descriptive statistical test of local governments in Indonesia, which describes the descriptive statistics of each variable. Table 2 shows the amount of data for each variable processed in this study, which amounted to 466 samples of local governments. The results of descriptive statistical testing show that the CAPEX variable has a minimum value of 0.000 and a maximum value of 0.448. The standard deviation value of the CAPEX variable is 0.067 or smaller than the average value of 0.181, so it can be concluded that there is no data deviation in the CAPEX data or the data does not have extreme variation. Meanwhile, the average value (mean) and median value of the CAPEX variable are 0.182 and 0.173. The CAPEX variable has an average value (mean) higher than the median, it can be concluded that the average CAPEX of local governments in Indonesia is high.

Table 2 Descriptive Statistics of Capital Expenditure and Local Government Size

Variables	Mean	Median	Std. Dev.	Min	Max	N
CAPEX	0.182	0.173	0.067	0.000	0.448	466
LGS	14.824	14.741	0.934	0.000	17.642	466

Note: CAPEX = Capital Expenditure; LGS : Local Government Size

The LGS variable has a minimum value of 0.000 and a maximum value of 17.642. The standard deviation value of the LGS variable is 0.934 or smaller than the average value of 14.824, it can be concluded that there is no data deviation in the LGS data or the data does not have extreme variation. Meanwhile, the average (mean) and median values of the LGS variable are 14.824 and 14.740. The LGS variable has a higher average (mean) than the median, so it can be concluded that the average LGS of local governments in Indonesia is high.

Table 2 Descriptive Statistics of FRQ Variables and Local Government Status

Variables	Frequency	Percent	Valid Percent	Cumulative Percent
<i>LGStt</i>				
Regency	379.00	79.30	813.00	81.30
City	87.00	26.50	26.50	100.00
Total	466.00	97.50	100.00	
<i>FRQ</i>				
TW	1.00	0.20	0.20	0.20
WDP	1.00	0.20	0.20	0.40
WTP	464.00	97.10	99.60	100.00
Total	466.00	97.50	100.00	

Note: LGStt = Local Government Status; FRQ = Financial Reporting Quality; TW = Not Reasonable; WDP = Reasonable With Exception; WTP = Unqualified

Table 3 presents a descriptive statistical table of LGStt variables and FRQ of local governments in Indonesia where in the table the amount of data for each variable processed in this study amounted to 466 samples of local governments.

The test results using descriptive statistical tests, it can be seen that the LGStt variable has a total frequency value of 466, of which 379 districts and 87 cities. The FRQ variable has a total frequency value of 466, where the opinion issued by SAA for Unreasonable opinion (TW) is 1, Unqualified opinion (WDP) is 1 and Unqualified opinion (WTP) is 464.

Classical Assumption Test

Research that will be tested using multiple linear regression methods must meet several assumptions. The assumptions that must be met are called classical assumptions which consist of normality test, autocorrelation test, heteroscedasticity test, and multicollinearity test. After testing, it was found that this study was free from the classical assumption test.

Hypothesis Test

The following are the results of hypothesis testing for equation I (without moderation):

Table 4 Multiple Regression Test Equation I

Variable	Coefficient	Prob.	Description
α	4.1065	0.0000	
CAPEX	0.1845	0.0047	Supported
LGS	0.0098	0.0267	Supported

Note: CAPEX = Capital Expenditure; LGS = Local Government Size

Based on Table 4, it can be written into the following equation:

$$\text{FRQ} = 4.1065 + 0.1845 \text{ CAPEX} + 0.0098 \text{ LGS}$$

Split Sampling Test

Table 5 Split Sampling Moderation Test: Local Government Status

Variable	Coefficient	Prob.	Description
<i>Moderation Test of Local Government Status (LGStt): City</i>			
α	4.3866	0.0000	
CAPEX	0.2434	0.1405	Not Supported
LGS	0.0291	0.0166	Supported
<i>Moderation Test of Local Government Status (LGStt): District</i>			
α	4.1065	0.0000	
CAPEX	0.1687	0.0328	Supported
LGS	0.0054	0.0452	Supported

Note: CAPEX = Capital Expenditure; LGS = Local Government Size; LGStt = Local Government Status

Split sampling test in this study to test the accuracy of the interaction model. The test results are as presented in Table 5. The results show that local government status (city vs district) moderates the relationship between capital expenditure (CAPEX) and government performance. In city governments, CAPEX has no significant effect on performance (coefficient = 0.2434; $p = 0.1405$), so the hypothesis is not supported. However, local government size (LGS) shows a significant effect (coefficient = 0.0291; $p = 0.0166$). In contrast, in district governments, both CAPEX (coefficient = 0.1687; $p = 0.0328$) and LGS (coefficient = 0.0054; $p = 0.0452$) have a significant effect on performance, which means the hypothesis is supported. These findings indicate that the effect of CAPEX on performance is more pronounced in district governments than in cities, while government size has a significant effect on both types of local governments.

Model feasibility test

The Moderated Regression Analysis regression equation in Table 6 shows that the prob value. F- statistic of 0.0349 or less than 0.05, it can be concluded that this research model is good or appropriate. In addition, the adjusted R-squared value of 0.1566 means that the CAPEX variable, LGS, the interaction of the CAPEX variable with LGStt and the interaction of the LGS variable with LGStt can explain the FRQ variable by 15.66%, while 84.34% is a variable outside this study.

Table 6 Model Feasibility Test

Description	Value
Adjusted R-squared	0.1566
Prob (F-statistic)	0.0349

The Effect of Capital Expenditure on Financial Reporting Quality

Based on Table 4, it can be concluded that CAPEX has a significant positive effect on the FRQ of local governments in Indonesia. This shows that the first hypothesis (H_1) is supported.

CAPEX in the regional budget reflects the local government's policy for development. In general, local budgets are activity plans and resource allocations for local governments, where these allocations describe local development funding policies. CAPEX is one of the priorities for local governments to support the welfare of the community (Mardiasmo, 2021) , One form of capital expenditure in local government is investment in the development of human resources, especially in accounting and finance, as well as the creation of infrastructure, and the establishment of financial systems that can support the financial reporting process, so as to produce good reporting quality.

Good CAPEX can improve the quality of financial statements because it ensures that capital expenditure is done with careful planning and for a clear purpose. Proper management of assets, financing, expenses, and risks related to capital expenditure will result in financial statements that are more transparent, accurate, and reflect good financial health.

In line with agency theory, local governments with a higher proportion of capital expenditure in their budgets will have higher management complexity, thus causing supervision both by the public, and the central government to be stricter, because the use of higher capital expenditure, local governments are required to carry out better management, and more transparent reporting, where this will improve FRQ in Indonesian local governments.

The Effect of Local Government Size on Financial Reporting Quality

Based on Table 4, it can be concluded that LGS has a significant positive effect on the FQR of local governments in Indonesia. This shows that the second hypothesis (H_2) is supported. The results of this test are in line with research conducted by Rakhman and Wijayana (2019) which shows that LGS has a significant positive effect on FRQ. This finding is also consistent with previous research which states that larger local governments are associated with greater compliance with accounting regulations (Christiaens, 1999) as well as greater transparency (Behn et al., 2010).

Governments that have a high wealth size will demonstrate a higher level of transparency to their stakeholders (Behn et al., 2010; Gordon et al., 2002; Guillamón et al., 2011), and are less likely to make errors in reporting (Gross & Neely, 2014), as well as more likely to voluntarily provide online or open financial information reports (Garcia & García-García, 2010). The larger the LGS, the more resources local governments will have which can produce better FRQ because it will lead to demands for better reporting transparency (Rakhman & Wijayana, 2019). Local governments with higher financial independence are considered richer because they derive more revenue from local sources, rather than from intergovernmental transfers. Richer local governments have greater resources to utilize information technology or hire consultants to support accounting systems, thus increasing the likelihood of producing higher quality financial statements.

In line with agency theory where to reduce information asymmetry that causes conflicts of interest between the agent (local government) and the principal (central government),

a good management and supervision system is needed, then local governments with more wealth caused by larger LGS are expected to be more transparent in their financial reporting, because the demand for quality financial reports will tend to be greater in local governments that have a large size. This is because the larger the size of the local government, the higher the local revenue, which will increase the opportunity to commit fraud, so that the public and the central government will carry out stricter supervision of the management of funds derived from local revenue (Tavares & da Cruz, 2020) .

The Effect of Capital Expenditure on Financial Reporting Quality with Local Government Status as Moderator

Based on Table 5, this split sampling test shows that local government status moderates the effect of CAPEX on performance. CAPEX only has a significant effect on district governments, not on cities. This may be due to differences in characteristics, development needs, or efficiency of budget use between cities and districts. In other words, the effect of CAPEX on improving performance is more pronounced at the district level.

Local governments in the era of decentralization are expected to be able to develop and increase PAD by maximizing the potential of existing resources to fund infrastructure projects and facilities through the allocation of capital expenditure in the regional budget. The greater the PAD of a region, the greater the capital expenditure budget (Ardhani, 2011). One form of capital expenditure in local government is investment in the development of human resources, especially in the fields of accounting and finance, as well as the creation of infrastructure, and the establishment of a financial system that can support the financial reporting process, so as to produce quality reports.

In line with agency theory, the greater the allocation of CAPEX, the more complex the management will be, in addition, CAPEX usually involves construction and procurement where corruption and bribery often occur (Neu et al., 2015; Sikka & Lehman, 2015). Therefore, local governments that have high capital expenditure are required to present transparent and good financial reports, especially if they have city status, where the public will tend to be more understanding and aware of the use of CAPEX. People in urban areas tend to have a higher level of education, so they are more actively involved in decision making in their local government (Yang & Callahan, 2005). One of them is in the form of monitoring the use and disclosure of better CAPEX.

The Effect of Local Government Size on Financial Reporting with Local Government Status as Moderator

Overall, the results of the study indicate that LGS has a significant effect on local government performance, both in cities and districts. However, the magnitude of the influence of LGS is stronger in cities than in districts, as reflected by the larger coefficient value. This indicates that the capacity and scale of local government are important factors in supporting performance, and the effect is more pronounced in larger and more complex areas such as cities.

This is because the relationship between the status of local government (city or district), local wealth, and the quality of financial statements is highly dependent on resource management, supervision, and accountability of local officials. With a good management system in local government agencies and aligned incentives from the central government, both cities and districts can produce quality, accurate and transparent financial reports (Guillamón et al., 2011). This is in line with the results of research by Kewo and Tanor (2020) which states that the better the governance system implemented in a government agency, the better the quality of the resulting financial statements.

In line with agency theory, where this theory states that control in modern corporations can lead to conflicts of interest between agents and principals (Klai & Omou, 2013; Triyuwono, 2018), where agents, may pursue their personal interests at the expense of the principal's interests, leading to suboptimal decision making. This fundamental agency problem has significant implications for the quality of financial reporting, as agents may be tempted to engage in earnings management or other forms of financial manipulation to portray better-than-real performance (Sitanggang et al., 2020; Affes & Jarboui, 2023). Existing literature highlights the important role of effective governance mechanisms in reducing agency conflicts and promoting high-quality financial reporting. Good governance structures, can help align the interests of principals and agents, thereby improving the reliability and transparency of financial information (Hutauruk, 2022; Sitanggang et al., 2020). Countries with strong financial reporting enforcement, both strong and weak governance structures can improve the quality of financial reporting, although the improvement is more significant in agencies with better governance (Bonetti et al., 2016).

Conclusion

This study was conducted to examine the determinants of FRQ in Indonesian local governments. This study uses the population of local governments in Indonesia in 2020. The independent variables tested in this study are CAPEX and LGS. Meanwhile, the dependent variable tested in this study is FRQ. This study also examines the interaction between the independent variable and the dependent variable using the moderating variable, namely local government status. The sample in this study was determined using a purposive sampling method, resulting in 466 local governments in Indonesia.

Based on the analysis and hypothesis testing that has been carried out on local governments in Indonesia in 2020, the following conclusions can be drawn: (1) CAPEX has a significant positive effect on FRQ; (2) LGS has a significant positive effect on FRQ; (3) LGStt significantly moderates the relationship between capital expenditure and FRQ; and (4) LGStt is unable to moderate the relationship LGS to FRQ.

The results of this study can be used as a consideration for local governments in Indonesia to improve transparency, accountability, and efficiency in public financial management. This can be achieved through strengthening oversight, increasing public participation, and implementing better information technology systems and improving the quality of

financial reporting. These practices can help local governments reduce waste, prevent budget abuse, and improve local financial management performance, which in turn supports the achievement of better and sustainable local development.

This research has several limitations including: (1) This study only uses data from local governments in Indonesia in 2020. The period or time span used is only 1 year, so the research period used is relatively short; (2) This study uses secondary data, therefore, it has not provided optimal results to determine the quality of FRQ in Indonesian local governments; (3) This study has not implemented the clustering of local governments in Indonesia as a control variable; (4) In LGStt and FRQ, the number of frequencies is quite unequal or the data is not balanced, this causes the statistical model used to analyze the data to provide inaccurate predictions. Models tend to prioritize larger groups, while smaller groups may be overlooked, thus reducing the ability of the model to generalize well.

The results of this study suggest several suggestions or recommendations that can be considered for future research, including: (1) Adding the research year period, so as to be able to produce more comprehensive values and observations of the research results; (2) Adding independent variables that might affect FRQ such as the Human Development Index; (3) Further research is recommended to use clustering of local governments as a control variable; (4) Future research for interaction tests if the data is binary should use dummy variables 1 and 2

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About the Authors

Satrio Kusumo Yudhanto (S.K.Y.) is graduated student of Master Accounting, Directorate of Postgraduate Program, Universitas Muhammadiyah Yogyakarta. Email: Satriokusumo34@gmail.com

Evi Rahmawati (E.R.) is lecturer at Master Accounting, Directorate of Postgraduate Program, Universitas Muhammadiyah Yogyakarta. Email: evirahmawati@umy.ac.id

Author Contributions

Conceptualisation, S.K.Y. and E.R.; Methodology, S.K.Y.; Investigation, S.K.Y.; Analysis, S.K.Y.; Original draft preparation, S.K.Y.; Review and editing, S.K.Y.; Visualization, S.K.Y.; Supervision, E.R.

Conflicts of Interest

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